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July 31, 1998

via facsimile and certified mail, return receipt requested

Mr. David S. Guzy
Chief, Rules and Publications Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165, M.S. 3021
Denver, Colorado 80225-0165

Re: Establishing Oil Value for Royalty Due on Federal Leases,
63 F.R. 36868, July 16, 1998

Dear Mr. Guzy:

Enclosed please find comments to be filed in the administrative record in the above captioned Federal Register notice. We are hereby also incorporating by reference the following comments previously filed in this matter which are relevant to the current MMS proposal:

- 1) *"Preliminary Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sales of Federal Royalty Oil",
Dated March 25, 1997*
- 2) *"Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sales of Federal Royalty Oil",
Dated May 28, 1997*
- 3) *"Analysis of the Department of Interior, Minerals Management Service Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Royalty Oil Under the Paperwork Reduction Act",
Dated August 4, 1997*

July 31, 1998

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- 4) *"Analysis of the Department of Interior, Minerals Management Service's Form MMS-4415 Under the Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases Under the Paperwork Reduction Act",
Dated March 10, 1998*
- 5) *"Analysis of the Department of Interior, Minerals Management Service's Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases",
Dated April 7, 1998*
- 6) *"Analysis of 'MMS' Economic Analysis of Proposed Federal Oil Valuation Rule Under Executive Order 12866",
Dated April 7, 1998*

Sincerely,



Patricia Dunmire Bragg
on behalf of:

Rocky Mountain Oil and Gas Association
Amoco Corporation
Anadarko Petroleum Corporation
Chevron U.S.A. Production
Conoco, Inc.
OXY USA, Inc.
Texaco, Inc.
Union Pacific Resources Company

**ANALYSIS OF THE DEPARTMENT OF INTERIOR,
MINERALS MANAGEMENT SERVICE'S SECOND FURTHER
SUPPLEMENTARY PROPOSED RULE ESTABLISHING
OIL VALUE FOR ROYALTY DUE ON FEDERAL LEASES**

PREPARED BY



A KPMG Company
2001 M Street, NW
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July 31, 1998

PREFACE

Barents Group LLC, a wholly owned subsidiary of KPMG Peat Marwick LLP, was retained by a group of companies having significant crude oil production on Federal lands, to assist in analyzing the Department of Interior, Minerals Management Service's (MMS) proposed rule establishing a new method for valuing oil for royalties due on Federal leases (63 F.R. 38355, published July 16, 1998). These companies are interested in and affected by the MMS proposal.

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EXECUTIVE SUMMARY

Barents Group LLC, a wholly owned subsidiary of KPMG Peat Marwick LLP, was retained by a group of companies having significant crude oil production on Federal lands, to assist in analyzing the Department of Interior, Minerals Management Service's (MMS) proposed rule establishing a new method for valuing oil for royalties due on Federal leases (63 F.R. 38355, published July 16, 1998). These companies are interested in and affected by the MMS proposal. This report addresses the specific concerns arising from the second further supplementary proposed rule and comments on issues outstanding from earlier versions of the proposed rule. As a result of our analysis of the proposed rule, and as discussed further below, MMS should fully commit its resources either to revising the existing regulations or to the further development of a viable royalty-in-kind program.

MMS published its original proposed rule on January 24, 1997, and in response to numerous comments, released the most recent version of the rule on July 16, 1998. The July 1998 version does not solve the problems contained in earlier versions of the rule and even creates new problems. The current version will allow MMS to "second-guess" values received in arm's-length transactions, and MMS' single exchange provision will significantly affect many independent producers by placing more of their transactions on an index valuation methodology.

- ◆ *Breach of Duty to Market.* Notwithstanding preamble language where MMS states that it will not second guess transactions, the proposed rule's provision concerning the breach of duty to market will allow MMS to second-guess the value received for crude oil under arm's-length contracts. Prices vary by location and from transaction to transaction as a function of supply and demand, and prices received in actual transactions will be distributed about a mean within a given area for a specific time period. The proposed rule allows MMS to require lessees with prices that MMS determines to be "substantially below market value" to value their production using a non-arm's-length methodology. No guidance is provided as to what "substantially below market value" means.
- ◆ *Single Exchange Provision.* MMS states that in response to comments received, it has reverted to the single exchange provision of the July 1997 rule. Under this provision, production first exchanged at arm's-length and then sold outright must be valued using gross proceeds. Any subsequent exchange will require the production to be valued based on a non-arm's-length methodology. This provision will require complex tracing through the second transaction and a complex calculation to arrive at royalty value. Further, following the prescribed methodologies will not result in accurate lease values.
- ◆ *Problems with earlier version of the rule still exist.* The July 1998 version of the rule fails to address many comments previously submitted to MMS.
 - ◇ The proposed methodology will not capture value at the lease.
 - ◇ Spot prices, even when adjusted for location and quality differentials, do not accurately reflect lease values.
 - ◇ MMS' proposed adjustments do not accurately capture differentials.
 - ◇ Data from Form MMS-4415 is not usable for its intended purpose.
 - ◇ The proposed methodology results in inaccurate values in each region.

- ♦ MMS must fully comply with all procedural requirements. These include requirements of the Administrative Procedures Act, Paperwork Reduction Act, Regulatory Flexibility Act, and Executive Order 12866.

The costs and inefficiencies that would be imposed on lessees by the further supplementary proposed rule are entirely avoidable and unnecessary because an active market exists for oil at the lease that would allow a more straightforward and less costly approach to royalty valuation. In addition, a serious, carefully developed, alternative approach is now under congressional consideration: royalty-in-kind (RIK). Two hearings have been held on RIK legislation and a bill has been reported by the Subcommittee on Energy and Mineral Resources of the House Committee on Resources. RIK legislation would require that the Federal government take royalty in kind production at the lease. By using private sector qualified marketing agents to market its production, the U.S. Government would achieve greater certainty than the proposed rule envisions but would do so in a way that is much less administratively burdensome, and clearly captures accurate arm's-length values through outright sales. Indeed, MMS has studied the feasibility of royalty-in-kind for natural gas in the Gulf of Mexico, has initiated a crude oil royalty-in-kind pilot program in Wyoming, and is initiating a crude oil royalty-in-kind pilot program for offshore Texas.

It makes little sense to completely restructure the current crude oil valuation system, as would be required if the further supplementary proposed rule were to be finalized, when serious efforts, including an MMS pilot program, are underway to develop a better system with broad industry support. A properly structured royalty-in-kind program will allow MMS to achieve its goals without the unnecessary administrative complexity and burden that would be imposed by MMS' second further supplementary proposed rule.

1. INTRODUCTION

On January 24, 1997, the Minerals Management Service (MMS) published a proposed rule establishing oil value for royalty due on Federal leases and on sale of Federal royalty oil (62 F.R. 3742). In compliance with the Paperwork Reduction Act of 1995 (PRA) and other statutory and regulatory requirements, MMS estimated the regulatory burden associated with the proposed rule and solicited comments.

On March 25, the Domestic Petroleum Council, the Independent Petroleum Association of America, the Independent Petroleum Association of Mountain States, the Mid-Continent Oil and Gas Association, and the Rocky Mountain Oil and Gas Association submitted a report prepared by Barents Group LLC (Barents) to the Office of Management and Budget (OMB) commenting on the proposed rule.¹ In response to these and other industry comments, as well as its own analysis, OMB denied MMS' request to collect information on proposed Form MMS-4415. The information to be collected on this form would be necessary to implement the proposed rule.

The Rocky Mountain Oil and Gas Association submitted a second report prepared by Barents to the Minerals Management Service (MMS) on May 28, 1997.² This second report presented a more substantive discussion of problems with the proposed rule, and concluded that the proposed valuation method based on New York Mercantile Exchange (NYMEX) futures prices and Alaska North Slope (ANS) spot prices in California was fundamentally and fatally flawed. The proposed rule failed to satisfy the basic objective of measuring the value of crude oil at the lease, and it imposed unnecessary costs and risks on Federal lessees and the Federal government. Additionally, the proposed rule would impose unnecessarily large administrative costs on lessees. Consequently, the report recommended that the proposed rule be withdrawn and its underlying valuation method rejected.

On July 3, MMS released a supplementary rule intended to address certain concerns raised during the comment period.³ Barents prepared a report filed by the Rocky Mountain Oil and Gas Association that reviewed the supplementary rule to analyze whether MMS had significantly reduced the paperwork burden. The report was submitted to OMB on August 4, 1997.⁴ In reviewing the July 3 supplementary rule, the Barents report concluded that while MMS had addressed certain relatively minor issues, MMS had not addressed the substantive issues raised by the industry or by OMB.

¹ "Preliminary Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sales of Federal Royalty Oil," March 25, 1997 as submitted by the Domestic Petroleum Council, the Independent Petroleum Association of America, the Independent Petroleum Association of Mountain States, the Mid-Continent Oil and Gas Association, and the Rocky Mountain Oil and Gas Association.

² "Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sales of Federal Royalty Oil," May 28, 1997 as submitted by the Rocky Mountain Oil and Gas Association.

³ 30 CFR Part 206 (62 FR 36030)

⁴ "Analysis of The Department of Interior, Minerals Management Service Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sale of Federal Royalty Oil Under the Paperwork Reduction Act," August 4, 1997 as submitted by the Rocky Mountain Oil and Gas Association.

MMS reopened the comment period on September 22, 1997 and requested comments on alternatives suggested by commenters before proceeding with the rulemaking. During that comment period, MMS held a number of workshops to discuss these valuation alternatives.⁵

On February 6, 1998, MMS released a further supplementary proposed rule after reviewing more than 2,600 pages of comments.⁶ Barents again prepared a report analyzing the further supplementary proposed rule. In reviewing the February 1998 rule, our analysis indicated that not only did many of the original problems remain, but the revised rule created new problems that rendered it unworkable.⁷

MMS has stated that it was prepared to publish a final oil valuation rule in June and, as a result of a congressionally-mandated moratorium, which prevents MMS from spending funds on developing a final rule until September 30, 1998, planned to publish a final rule in October. The appropriations bill for the Department of the Interior now contains language that, if enacted, would prevent a final rule from going into effect before October 1, 1999.

MMS reopened the comment period on the proposed rule on July 8, 1998 and published a second further supplementary proposed rule on July 16, 1998⁸ "in response to comments received so far."⁹ The second further supplementary proposed rule makes only three changes to the February 6, 1998 version. The revised rule does not address the fundamental problems inherent in the index price approach taken by the rule, and does not address the comments raised in previous Barents reports filed with MMS.

We begin with an overview of the proposed rule, the supplementary proposed rule, the further supplementary proposed rule, and the second further supplementary proposed rule (Section 2). Section 3 discusses problems with the second further supplementary proposed rule. Section 4 discusses outstanding issues from previous versions of the rule. Section 5 discusses procedural issues. Finally, Section 6 presents our conclusions.

⁵ On November 5, 1997, a Barents Group report entitled "Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sale of Federal Royalty Oil Under Executive Order 12866" and submitted by the Rocky Mountain Oil and Gas Association called for MMS to complete an Executive Order 12866 analysis of its proposed rule.

⁶ All references to the further supplementary proposed rule in this report refer to 30 CFR Part 206. (63 FR 6113)

⁷ "Analysis of The Department of Interior, Minerals Management Service's Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases," April 7, 1998 as filed by the Rocky Mountain Oil and Gas Association.

⁸ 63 FR 38355

⁹ 63 FR 38356

2. OVERVIEW OF PROPOSED OIL VALUATION RULES

This section briefly discusses the proposed rule as it has continued to evolve from its original form in January 1997 to its most recent iteration in July 1998.

ORIGINAL PROPOSED RULE

The original proposed rule sought to decrease reliance on posted prices and to develop rules for Federal royalty valuation which would better reflect market value of crude oil at the lease.¹⁰ It retained the concept that for arm's-length sales, gross proceeds are the basis of royalty value, but limited the application of this concept. The majority of sales would be subject to a new index methodology in which the royalty value is linked to either the New York Mercantile Exchange (NYMEX) futures price for West Texas Intermediate (WTI) at Cushing, Oklahoma or the Alaska North Slope (ANS) spot price for deliveries in either Los Angeles or San Francisco, depending on the location of production. The transactions required to use this new methodology included exchange agreements, reciprocal buy/sell agreements, non-arm's length transactions, sales to an affiliate refiner, and production subject to a crude oil call, and arm's-length sales by lessees who have purchased crude oil within the preceding two years. The proposed rule also required lessees to file a new form, Form MMS-4415, for all exchange agreements. The information collected on the new form was to be used to calculate location/quality differentials between aggregation points and market centers.

Proposed Form MMS-4415, in its original version, would have imposed new reporting and record-keeping burdens on Federal lessees. Initially, the form was to be submitted no later than two months after the effective date of the information requirement and then by October 31 of the year in which the rule takes effect and by October 31 of each succeeding year. The form requested information on the terms of the contract including: contract party name, contract type and ID, contract term, title transfer location, volume terms, crude quality (including API gravity and sulfur content), pricing terms, and quality adjustments.

Royalty valuation at the lease for non-arm's-length transactions was proposed as follows: Where oil is transferred to an affiliate who later sells it at arm's length, the value of the oil for royalty purposes would be either:

1. the affiliate's arm's-length resale price (provided that neither the lessee nor its affiliate also purchases oil); or
2. a "monthly average" of the NYMEX futures price (for non-California and non-Alaska oil) or ANS spot price (for oil produced in California or Alaska), adjusted for location and/or quality differentials.

For all other cases (i.e., where the lessee or its affiliate refines the oil or disposes of it in a non-arm's-length transaction), only the second option would be available.

¹⁰ All references to the original proposed rule in this report refer to 30 CFR Part 206 (62 FR 3742)

MMS described three adjustments to the "monthly average" NYMEX futures price:

1. a location/quality differential between the index pricing point (for example, West Texas Intermediate (WTI) at Cushing, Oklahoma) and the appropriate market center (for example, Light Louisiana Sweet at St. James, Louisiana), calculated as the difference between the average monthly spot prices published in an MMS-approved publication for the respective locations;
2. a location/quality differential between the market center and a major aggregation point for oil from various sources, as either published by MMS or contained in the lessee's arm's-length exchange agreement (this adjustment would be based on data collected on Form MMS-4415) or the company's own differential on a buy/sell or exchange between a market center and an aggregation point; and
3. the actual costs of transportation (as determined under existing valuation rules) from the aggregation point to the lease, or from the market center to the lease if the oil flows directly to a market center.

SUPPLEMENTARY PROPOSED RULE

On July 3, 1997, MMS published a supplementary proposed rule that modified the eligibility requirements for oil valuation for arm's-length transactions and the procedures for collection of exchange information.¹¹ It also amended the list of aggregation points. This section discusses changes to the proposed rule contained in the supplementary proposed rule.

Modifications in Reporting Requirements

The supplementary proposed rule did not significantly change the reporting requirements of proposed Form MMS-4415. It contained no changes to either the proposed form or its instructions. The only change in reporting requirements was that MMS would only require Form MMS-4415 to be filed for transactions between an aggregation point and a market center and would not require a Form MMS-4415 to be filed for oil exchanged at the lease.

Modifications in Valuation Methodology

Under the original proposed rule, MMS would have required that all production subject to a crude oil call be valued using the proposed index methodology. MMS received many comments regarding oil subject to crude oil calls; crude oil calls are frequently not exercised, and when they are exercised, the purchaser must typically match or exceed the price offered by the highest bidder. In these cases, MMS would not have required the oil to be valued using an index pricing method. The supplementary proposed rule amended proposed 30 CFR 206.102(a)(4) to require index valuation only in situations involving non-competitive crude oil calls and added a definition of a non-competitive crude oil call in 30 CFR 206.101. The supplementary proposed rule also deleted 30 CFR 206.102(a)(6), as proposed in January, to address the issue that

¹¹ 62 FR 36030

disallowing producers who purchased small quantities of oil for on-lease and other uses from using the gross proceeds method was too restrictive.

MMS proposed a new paragraph (a)(6) to allow producers who exchange oil with a non-affiliated entity, and then sell the oil in an arm's-length transaction, to value that oil using gross proceeds or to choose to use an index methodology. This paragraph would only apply if there were a single exchange agreement before the arm's length sale.

MMS also proposed to exclude an additional category of arm's-length transactions from gross proceeds valuation. The preamble states "[t]hat these are situations where two parties transact purchases and sales of oil that would appear to be arm's length. However, the prices are below market for the field or area. Neither party cares because they agree to sell roughly equivalent volumes to one another..."¹² In this situation, referred to as an "overall balance" situation, the supplementary proposed rule would amend 30 CFR 206.102(a)(4) to require the oil to be valued based on index value.

Finally, MMS amended proposed 30 CFR 206.102(a)(1) to clarify that the exceptions to valuing oil based on gross proceeds should be applied on a contract-by-contract or transaction-by-transaction basis.

FURTHER SUPPLEMENTARY PROPOSED RULE

On February 6, 1998, MMS published a further supplementary proposed rule which retains the concept of index pricing, but would require the use of spot prices published for the market center nearest the lease for oil most similar in quality to the lease production rather than NYMEX. Additionally, it divides the United States into three geographic regions for purposes of valuing oil disposed of in non-arm's-length transactions for Federal royalty purposes. The use of an Alaska North Slope (ANS) index for production from Alaska and California was retained from the original proposed rule.

Modifications in Reporting Requirements

The further supplementary proposed rule proposes a slightly modified Form MMS-4415 which would need to be filed for all the lessee's and their affiliates' crude oil production from Federal leases which is exchanged under arm's-length exchange agreements between paired aggregation points and market centers. The revised form requests the following information: lessee name and address; lessee payor code; reporting period; contract party name; exchange party payor, if available; contract type and contract number; the effective date, initial term, and expiration terms of the contract; the aggregation point and market center; the volume of oil transferred or received; the exchange differential received or paid; and certain quality information and adjustments including API gravity (either deemed or actual), the gravity adjustment received or paid, the actual or deemed sulfur content, the sulfur adjustment received or paid, and any other quality adjustment and the amount received or paid.

¹² 62 FR 36031

Modifications in Valuation Methodology

Under the further supplementary proposed rule, the value of crude oil for royalty purposes is the *gross proceeds* accruing to the seller less applicable allowances.¹³ This also applies if oil is transferred under multiple non-arm's-length contracts and ultimately sold at arm's length, regardless of the number of non-arm's-length transfers before the final sale. The following adjustments are allowed for arm's-length sales:

- ◆ A location/quality differential determined from an arm's-length exchange agreement reflecting the difference in value between an aggregation point and a market center or between a lease and a market center;
- ◆ Actual transportation costs between an aggregation point and a lease; and
- ◆ Quality adjustments based on premia or penalties determined by pipeline quality bank specifications at intermediate commingling points, at the aggregation point, or at the market center that applies to the lease.

There are four exceptions to the gross proceeds rule, and these include:

1. MMS may require the lessee to value oil as non-arm's length if MMS determines that an arm's-length contract does not reflect the total consideration actually transferred;
2. The lessee must value oil as non-arm's-length if MMS determines that gross proceeds do not reflect a reasonable value because of misconduct by either party to the arm's-length contract or a breach of the duty to market the oil for the mutual benefit of the lessee and lessor;
3. Oil is disposed of under a non-arm's-length exchange; or
4. Oil is subject to a noncompetitive crude oil call.

Oil falling under these exceptions must be valued using the methodology for non-arm's-length transactions.

The non-arm's-length methodology is now separated into three regional schemes. For *production in California and Alaska*, the value of crude oil would be the average of the daily mean ANS spot prices adjusted for applicable location and quality differentials and possibly for transportation costs.

In the Rocky Mountain Area,¹⁴ crude oil would be valued using a system of four benchmarks:

1. Values established by an MMS-approved tendering program;
2. The volume-weighted average gross proceeds received;

¹³ Note that gross proceeds is a defined term that is not the same as the definition of gross proceeds under current regulations. As Ben Dillon, Vice President of the Independent Petroleum Association of America, noted in his comments at the MMS hearing on the further supplementary proposed rule on February 25, 1998, "[MMS] inserted into gross proceeds the word 'market' and implied duty versus marketable condition."

¹⁴ The Rocky Mountain Area is a defined term and means the States of Colorado, Montana, North Dakota, South Dakota, Utah, and Wyoming.

3. The average of daily NYMEX futures prices adjusted for applicable location and quality differentials and possibly for transportation; or
4. An alternative established by the MMS Director.

The rest of the country would use average daily mean spot prices for the market center nearest the lease where spot prices are published in an MMS-approved publication for the crude oil most similar in quality to the lease production. This spot price must then be adjusted for location and quality differentials and may be adjusted for transportation costs. MMS is not proposing to allow the costs of marketing production to be deducted.

The following deductions would be allowed for oil valued using these non-arm's-length methodologies:

- ◆ If production moved directly to alternate disposal point:
 - ◊ Actual transportation costs between the aggregation point and the lease (treat alternate disposal point as aggregation point);¹⁵
 - ◊ Quality adjustments based on premia or penalties determined by pipeline quality bank specifications at intermediate commingling points, at the aggregation point, or at the market center that applies to the lease.¹⁶
- ◆ If production moved directly to an MMS-identified market center:
 - ◊ Actual transportation costs between the market center and the lease;¹⁷
 - ◊ Quality adjustments based on premia or penalties determined by pipeline quality bank specifications at intermediate commingling points, at the aggregation point, or at the market center that applies to the lease.¹⁸
- ◆ If production neither moved to an alternate disposal point or to a market center:
 - ◊ An MMS-specified location/quality differential determined from an arm's-length exchange agreement that reflects difference in value of crude oil between the aggregation point and the market center;¹⁹
 - ◊ MMS will publish annually a series of differentials applicable to various aggregation points and market centers based on data collected on Form MMS-4415. MMS will calculate each differential using a volume-weighted average of differentials reported for similar quality crudes for the aggregation point, market center pair for the last year. These differentials will be used for that calendar year.²⁰

¹⁵ Proposed Section 206.112(c)

¹⁶ Proposed Section 206.112(c)

¹⁷ Proposed Section 206.112(d)

¹⁸ Proposed Section 206.112(e)

¹⁹ Proposed Section 206.112(b)(1)

²⁰ Proposed Sections 206.112(b)(2) and (3)

- o Actual transportation costs between the aggregation point and the lease (treat alternate disposal point as aggregation point);²¹

Quality adjustments based on premia or penalties determined by pipeline quality bank specifications at intermediate commingling points, at the aggregation point, or at the market center that applies to the lease.²²

SECOND FURTHER SUPPLEMENTARY PROPOSED RULE

On July 16, 1998, eight days after announcing that it was reopening the comment period in the proposed oil valuation rule for two weeks, MMS published a second further supplementary proposed oil valuation rule.²³ MMS states that it is proposing some changes to its February 6, 1998 further supplementary proposed rule "in response to comments received so far."²⁴ The further supplementary proposed rule contains three changes and one request for comment.

Definition of Affiliate

The July 16, 1998 version of the proposed rule changes the proposed definition of "affiliate" back to the current law definition. The original proposed rule had changed the definition of affiliate so that 10 percent ownership was the threshold for defining control. Under the latest version of the rule, less than 10 percent ownership creates a presumption of non-control; ownership of between 10 and 50 percent creates a rebuttable presumption of control; and ownership in excess of 50 percent establishes control.

Breach of Duty to Market

MMS has altered the language in §206.102(c)(2) to address commenter concerns that MMS would "second-guess" a lessee's marketing decision. The language now reads as follows:

You must value the oil under §206.103 if MMS determines that the value under paragraph (a) of this section [§206.102] does not reflect the reasonable value of the production due to either:

- (i) Misconduct by or between the parties to the arm's-length contract; or*
- (ii) Breach of your duty to market the oil for the mutual benefit of yourself and the lessor. MMS will not use this provision to dispute lessees' marketing decisions made reasonably and in good faith. It will apply only when a lessee or its affiliate inappropriately sells its oil at a price substantially below market value.²⁵*

Exchanges

Under the February 1998 proposed rule, crude oil ultimately disposed of in an arm's-length disposition was required to be valued based on the gross proceeds resulting from the ultimate

²¹ Proposed Section 206.112(c)

²² Proposed Section 206.112(e)

²³ 63 FR 38355

²⁴ 63 FR 38356

²⁵ 63 FR 38357

arm's-length sale. The July 1998 version of the proposed rule changes this provision so that oil must be valued based on gross proceeds if it is sold at arm's-length after only one arm's-length exchange, and it must be valued using a non-arm's-length methodology if it is exchanged more than once before an outright sale. If MMS determines that any arm's-length exchange agreement does not reflect reasonable location and quality differentials, MMS may require the lessee to value the oil under §206.103.

Gathering vs. Transportation

MMS is also asking for comments on whether the definition of gathering should be modified to address situations where unseparated production is moved long distances to a platform where it first surfaces and is treated.

3. COMMENTS ON SECOND FURTHER SUPPLEMENTARY RULE

DEFINITION OF AFFILIATE

The July 1998 version of the proposed rule returns to the current law definition of affiliate. If a control-based definition is part of the final rule, then standards are still needed to provide guidance on rebutting the presumption of control for ownership of between 10 and 50 percent.

BREACH OF DUTY TO MARKET

MMS states in the preamble that the revised language in the second further supplementary proposed rule is "to clarify that the lessee's duty to market does not mean that MMS will second-guess a company's marketing decisions... The provision's purpose is to protect royalty value if, for example, a lessee were to inappropriately enter into a substantially below-market transaction for the purpose of reducing royalty."²⁶ The language of the rule as written, however, leaves terms undefined and, as a result, provides the opportunity for MMS to require lessees, with legitimate arm's-length contracts, to pay higher royalties.

The revised language states that MMS will use this provision "only when a lessee or its affiliate inappropriately sells its oil at a price substantially below market value."²⁷ The term "market value" is not defined, nor does MMS define what it means by "substantially below." The term "market value" is a very broad term; it is not clear which market MMS would use in determining value. Lease market values, for example, may be very different from spot market values. "Substantially below" is a subjective term and the proposed rule establishes no guidelines. Further, the proposed rule states that "MMS will not use this provision to dispute lessees' marketing decisions made reasonably and in good faith."²⁸ These too are subjective terms, and do not appear to provide any certainty or guarantee that MMS will not "second-guess" a lessee's decisions.

On any given day, at any given location, for a given quality of crude, market prices will vary based on local supply and demand conditions in effect at the time of the transaction. As such, it is possible for each producer to sell its crude oil at arm's length at a different price, where each price will be a valid market price. Comments filed by Dr. Joseph Kalt of Harvard University and The Economics Resource Group, Inc. on May 27, 1997 state that data Dr. Kalt has collected and reviewed indicate that "arm's-length, comparable transactions in a given oil field at any given point in time consistently occur within a range of prices, rather than at a single, common price. This range demonstrates the influence of highly localized supply and demand factors which

²⁶ 63 FR 38356

²⁷ 63 FR 38357

²⁸ 63 FR 38357

cause value differences of significant magnitudes even among comparable arm's-length transactions occurring in the same field at the same time."²⁹

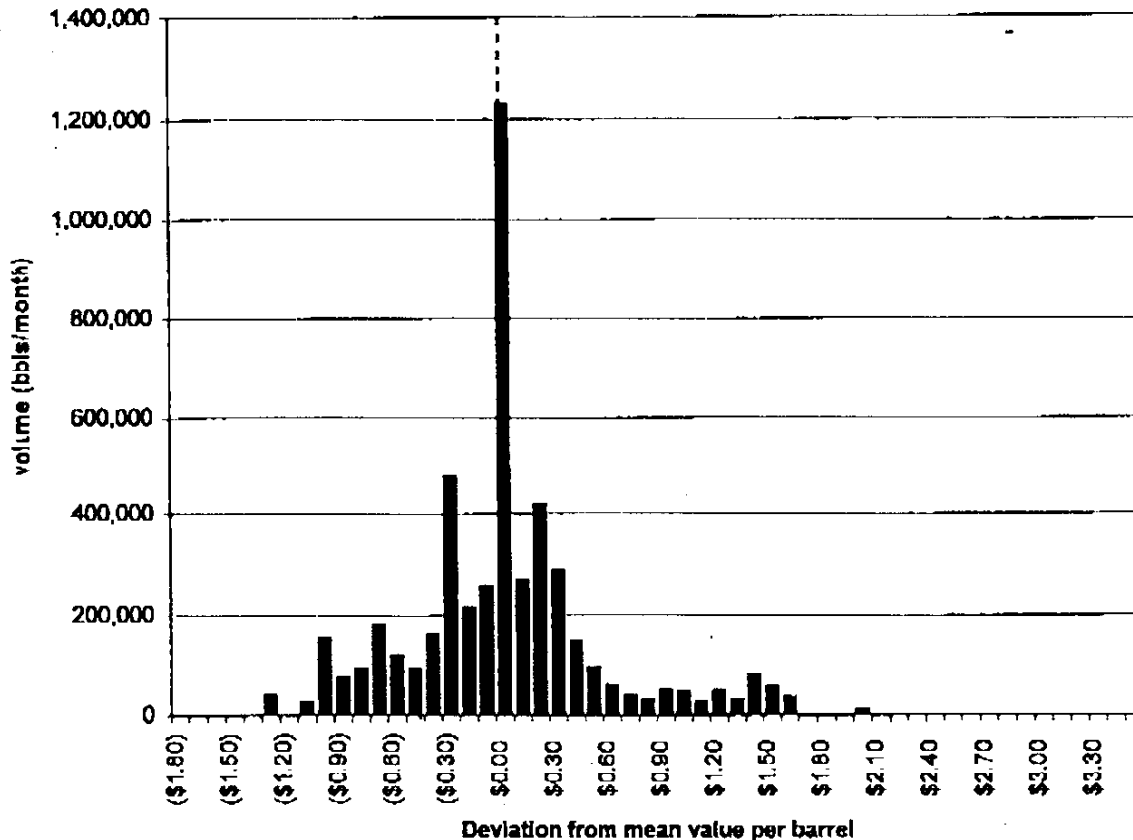
The following charts illustrate the variation in prices received over a given month for a given field. Figure 1 shows the deviation from the mean value per barrel for all producers in offshore California. These deviations were derived on a field-by-field and month-by-month basis.³⁰ Figure 1 clearly shows a distribution of values both above and below the mean³¹ and illustrates the ranges of values reported. The dashed line indicates the mean deviation.

²⁹ Comments of Joseph P. Kalt, Harvard University and The Economics Resource Group, Inc., May 27, 1997. Page 4.

³⁰ These data were obtained from MMS through Freedom of Information Act request. To calculate the deviations, we first calculated an adjusted, volume-weighted average value per barrel and calculated the deviation from that volume-weighted average on a payor-by-payor basis for each month and each field. The chart shows deviations from the mean for all fields and all months. We have excluded data for fields that appear to have a single payor because there is no deviation from a mean value to be measured. All data are for 1996. The data received from MMS under the FOIA request also contained an adjustment for transportation to Los Angeles, a gravity adjustment to 27° API, and a sulfur adjustment that we have used in this analysis.

³¹ Figures 1 and 2 classify volumes in 10-cent per barrel ranges. Thus, the mean value is a band between \$0.05 and - \$0.05.

Figure 1
Deviation from Mean Value per Barrel for All Producers
Offshore California, 1996
 (adjusted for comparable quality and location)

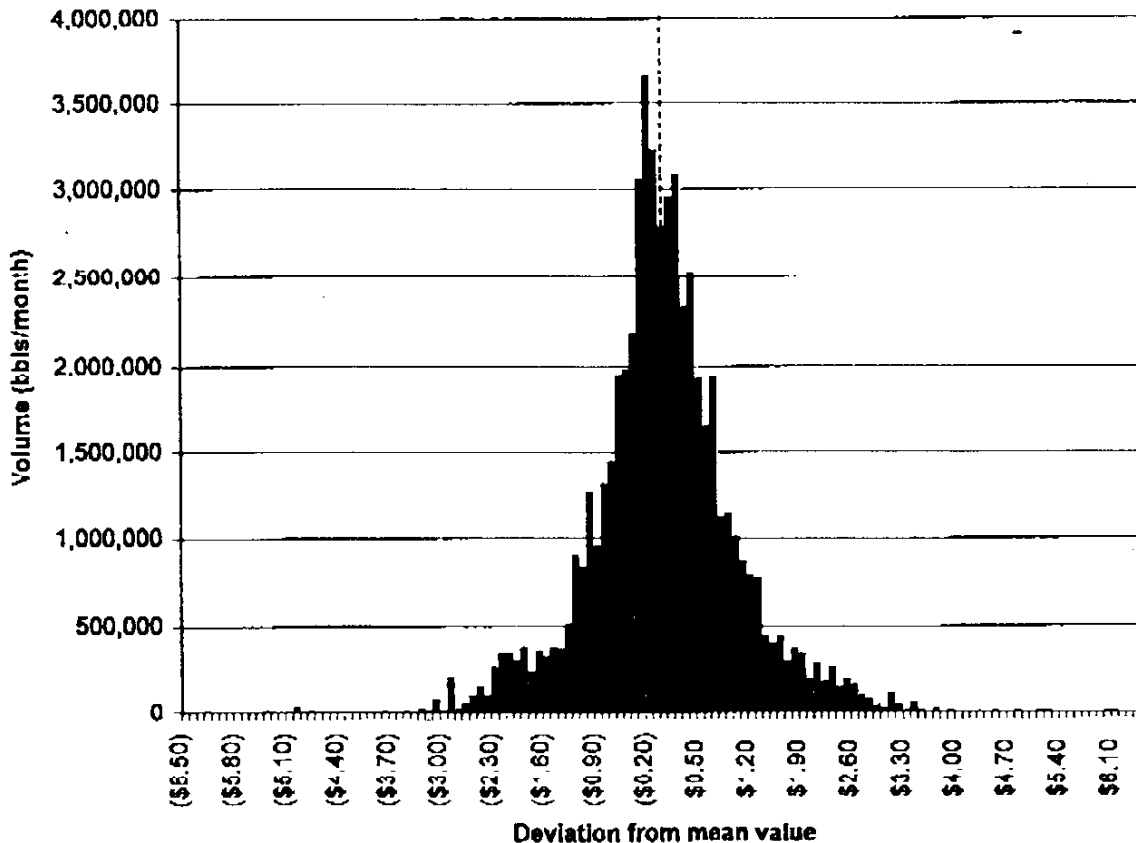


Under the proposed rule, MMS may require lessees to value crude oil using a non-arm's-length method if it determines that the lessee "inappropriately sells its oil at a price substantially below market value."³² If, for example, MMS inappropriately treats the mean reported value as "market value," then those lessees with values "substantially below" the mean could be second-guessed and required to revalue their oil using an index price or one of the Rocky Mountain Area benchmarks, depending on the location of production. In this example, 39 percent of monthly volumes fall below the mean.

The Gulf of Mexico shows a similar pattern to offshore California, although, in the Gulf of Mexico, there are many more transactions and a wider distribution of prices around the mean. Figure 2 shows the distribution of values reported above and below the mean; the dashed line indicates the mean.

³² 63 FR 38357

Figure 2
Deviation from Mean Value per Barrel for All Producers
Gulf of Mexico, 1996
 (adjusted for comparable quality and location)



For all Gulf of Mexico producers, 49 percent of production has reported values below the mean, 5 percent has reported values within \$0.05 either side of the mean, and 47 percent of reported volumes are above the mean. If the distribution of values for volumes reported using gross proceeds is similar to that shown in Figure 2 and MMS determines that the mean value reported represents "market value," it could require almost half of the production valued under the gross proceeds methodology in the Gulf to be revalued using the index methodology.

These charts demonstrate that values vary significantly about the mean and all may represent "market value." The rule, however, provides MMS with the latitude to second-guess values and require revaluation where it deems the reported amount to be "substantially below market value" without defining what those terms mean.

MMS states in the preamble to the July 1998 version of the proposed rule that 30 CFR §206.102(c)(2)(ii) is identical to the provision in the existing rules at 30 CFR §206.102(b)(1)(iii). The existing provision, however, contains a mechanism through which the lessee has an opportunity to provide written justification of the value it received. No such mechanism appears

to exist in the proposed language. Further the proposed language adds the undefined or subjective terms "reasonably and in good faith," "substantially below," and "market value."

In short, the revised language will provide MMS with an expanded ability to second-guess the lessee's marketing decision and increases the uncertainty in using the gross proceeds method, contrary to MMS' stated intention in promulgating the new rule in the first instance. -

EXCHANGES

As described above, the second further supplementary proposed rule requires that production that is exchanged once at arm's-length and then is sold outright be valued using the gross proceeds methodology. Production exchanged at arm's-length more than once is valued using the non-arm's-length methodologies. MMS states that it made this change in response to comments that the provision in the February 1998 version of the rule, which required production to be based on gross proceeds at the point of outright sale regardless of the number of exchanges that occurred before that sale, would result in overly burdensome tracing of multiple transactions. While the revised provision sounds simpler than the February provision, it will, in fact, still require the same complex and burdensome tracing of transactions.

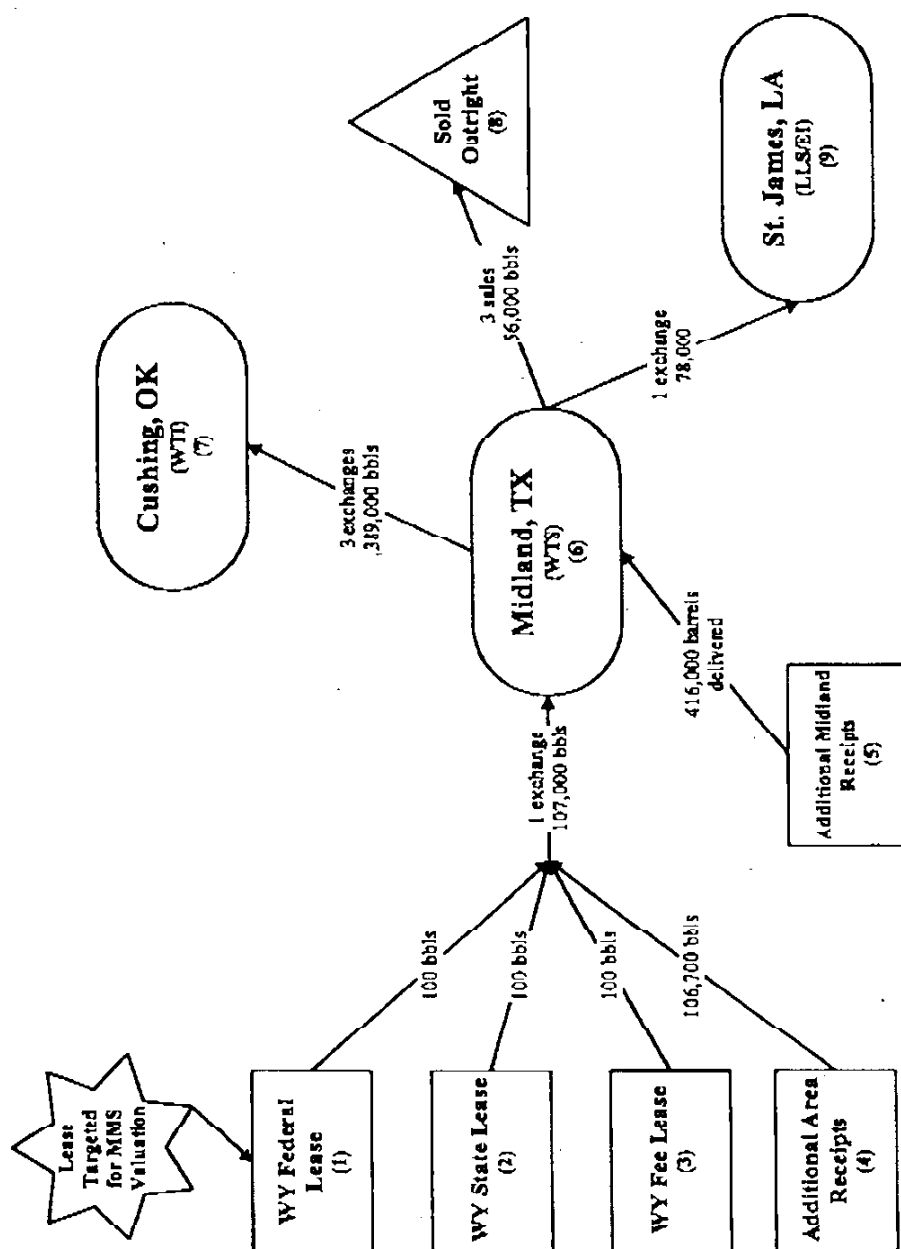
In order to know how to value its production, a lessee will be required to trace all transactions through the second transaction. While this may not sound complicated and burdensome, it is, in fact, much less simple than it sounds. Further, the calculations required for valuation will be complex, and "if MMS determines that any arm's-length exchange agreement does not reflect reasonable location or quality differentials, MMS may require [the lessee] to value the oil under §205.103 [non-arms-length methodologies]."³³ Location and quality differentials are critical to the operation of the proposed rule, and previous Barents comments filed with MMS have discussed problems with MMS' methodology for computing location and quality differentials at length.³⁴ The proposed rule provides no guidance as to what "reasonable location or quality differentials" are. Therefore, after having traced numerous transactions, the lessee may be required to value its production based on either index or one of the Rocky Mountain Area benchmarks depending on the location of production.

Figure 3 shows an example of marketplace transactions. In Figure 3, there is only one Federal lease for which we must derive a value for the 100 Federal barrels produced. As this is an onshore lease, royalty is due on one-eighth of the value of the crude.

³³ 63 FR 38357

³⁴ "Preliminary Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sales of Federal Royalty Oil," March 25, 1997 as submitted by the Domestic Petroleum Council, the Independent Petroleum Association of America, the Independent Petroleum Association of Mountain States, the Mid-Continent Oil and Gas Association, and the Rocky Mountain Oil and Gas Association; "Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sales of Federal Royalty Oil," May 28, 1997 as submitted by the Rocky Mountain Oil and Gas Association; "Analysis of MMS' 'Economic Analysis of Proposed Federal Oil Valuation Rule Under Executive Order 12866,'" April 7, 1998 as filed by the Rocky Mountain Oil and Gas Association; and "Analysis of the Department of the Interior, Minerals Management Service's Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases," April 7, 1998 as filed by the Rocky Mountain Oil and Gas Association.

Figure 3
Example of Market Place Transactions



July 31, 1998

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The Figure 3 example shows one possible way in which the lessee could be required to calculate value under the proposed rule, but because of the inherent complexity and lack of clarity associated with the proposed rule, this example should merely be considered as one of many possible representations of how value could be calculated. Required calculations under the proposed rule could be vastly more complicated.

- ◆ One hundred barrels of crude oil from the Federal lease (see 1 on the chart) is commingled with 100 barrels of production from one of the lessee's state leases (see 2 on the chart), 100 barrels of production from one of the lessee's fee leases (see 3 on the chart), and 106,700 barrels of production from the lessee's other leases (see 4 on the chart) for a total of 107,000.
- ◆ These 107,000 barrels are exchanged to Midland in one arm's-length transaction.
- ◆ At Midland (6 on the chart), these 107,000 are commingled with 416,000 barrels of the lessee's production from other locations (see 5 on the chart) for a total of 523,000. Of these barrels:
 - 78,000 are exchanged to St. James in one transaction (see 9 on the chart). As this is the second exchange, and the lessee must assume that some number of the lessee's 100 Federal barrels are included in this 78,000, the Federal portion must be valued using a non-arm's-length methodology. As the Federal production came from a Wyoming lease, it must be valued using the first applicable of the Rocky Mountain Area benchmarks. Once a value has been determined for the 78,000 barrels exchanged to St. James using the Rocky Mountain Area benchmarks, it must be multiplied by $100/523,000$ or 0.000191 .
 - 389,000 barrels are exchanged to Cushing, OK in three transactions (see 7 on the chart). As this is the second exchange, and the lessee must assume that some number of the lessee's 100 Federal barrels are included in this 78,000, the Federal portion must be valued using a non-arm's-length methodology. Once a value has been determined for the 389,000 barrels exchanged to Cushing using the Rocky Mountain Area benchmarks, it must be multiplied by $100/523,000$ or 0.000191 .
 - 56,000 barrels are sold outright in three separate, arm's-length transactions (see 8 on the chart). For each sales contract, the lessee must determine the price received in the sale and the allowable deductions. As this production was initially exchanged in an arm's-length transaction, the lessee may adjust the value for any location or quality differentials or other adjustments received or paid under the arm's-length agreement. The gross proceeds less an adjustment for any location or quality differentials or other adjustments received or paid from each sale must be multiplied by $100/523,000$ or 0.000191 . In this example, we assume two sales of 20,000 barrels and one of 16,000 barrels.
- ◆ Under these assumed facts and interpretation of the rule, the weighted average value of the Federal production would be as follows:

Weighted average value =

$$\begin{aligned} & 100/523,000 * 78,000 * \text{Value}_{(\text{St James based on Rockies benchmarks})} + \\ & 100/523,000 * 389,000 * \text{Value}_{(\text{Cushing based on Rockies benchmarks})} + \\ & 100/523,000 * 20,000 * \text{Value}_{(\text{Sale 1 less adjustment per exchange agreement})} + \\ & 100/523,000 * 20,000 * \text{Value}_{(\text{Sale 2 less adjustment per exchange agreement})} + \\ & 100/523,000 * 16,000 * \text{Value}_{(\text{Sale 3 less adjustment per exchange agreement})} \end{aligned}$$

- ◆ Of the 78,000 barrels exchanged to St. James, less than 15 barrels are included in the value of the Federal crude. Of the 389,000 barrels exchanged to Cushing, 74 barrels are included in the value of the Federal crude. Of the 20,000 barrels sold in sale 1, less than 4 barrels are included in the value of the Federal crude. Of the 20,000 barrels sold in sale 2, less than 4 barrels are included in the value of the Federal crude. Of the 16,000 barrels sold in sale 3, just over 3 barrels are included in the value of the Federal crude.

As this example illustrates, it is a complex process to arrive at value for royalty purposes. The lessee must first trace all transactions through the second transaction in the chain. For each second transaction, the lessee must determine whether the crude should be valued using the gross proceeds methodology with appropriate allowances or using a non-arm's-length methodology that will vary depending on the location of production. In this example, we are assuming that no Federal production from any other region has been commingled with the Federal production from Wyoming. If Federal production from New Mexico or Louisiana had been exchanged to Midland, the process would become much more complex. It would become more complex still if Federal production from California is also exchanged to Midland.

In addition, if any of the volumes initially changed in subsequent months due to, for example, run ticket errors, all of the calculations will have to be re-computed, and the lessee will be required to file adjustments on Form MMS-2014. This adds to the already burdensome process and will exponentially increase the number of lines reported.³⁵

Further, it is unlikely that following the methodology described above will result in an accurate lease value. As we have discussed in previous reports, the proposed methodology will not capture value at the lease.

In its July 24, 1998 "Summary of Industry recommended Improvements to MMS Oil Valuation Proposed Regulations and MMS Responses Discussed at July 22, 1998, Senate Meeting," MMS requests comments on which of three alternative arm's-length exchange valuation methodologies best reflect industry position on this issue. MMS presents the following three options:

- ◆ The July 1998 proposal to use the "first-exchange" rule where value will be determined based on the arm's-length sale after a single arm's-length exchange, or

³⁵ For further discussion of the impact on Form MMS-2014 see "Analysis of the Department of the Interior, Minerals Management Service's Request for Extension of the Existing Collection Authority for Form MMS-2014," dated June 22, 1998, and "Analysis of the Department of the Interior, Minerals Management Service's Request for Extension of the Existing Collection Authority for Form MMS-2014," dated March 6, 1998.

- ◆ The February 1998 proposal to expand gross proceeds valuation to include situations where the oil received in exchange is ultimately sold at arm's length, regardless of the number of arm's-length exchanges involved, or
- ◆ The July 1997 proposal that allowed the lessee the option of valuing exchanged oil using either 1) its gross proceeds under an arm's-length sale after the exchange(s) or 2) the index pricing method. That election would be for a 2-year period and the lessee must value all oil production disposed of under all of its arm's-length exchange agreements in the same manner.

We have previously commented on each of these options and found flaws with each. As discussed above, the July 1998 version does not simplify the tracing requirement and still requires complex calculations to arrive at value for royalty purposes. The February 1998 proposal places an enormous burden on lessees to trace all transactions until final disposition into either its own or its affiliate's refinery, or in an arm's-length sale to a third party.³⁶ In the first instance, the lessee is ultimately required to use the index price method, while in the second, the lessee must use a value determined from a sale in a downstream market. In neither case does the methodology represent value at the lease. The July 1997 proposal, while providing lessees with the option of using gross proceeds or the index method for valuing exchanged oil, locks lessees into that decision for two years. It further requires lessees to use the chosen methodology for valuing all crude oil exchanged under arm's-length contracts regardless of circumstance. As with the February 1998 proposal, neither methodology arrives at an accurate measure of lease value.

While the July 1997 proposal provides more administrative flexibility, it generally fails to capture lease value. The range of options previously put forward by industry members includes: tendering, reliance on comparable arm's-length transactions, or a methodology to net back to the lease from an index price or affiliate resales with appropriate deductions to achieve lease value.

At the July 22, 1998 Senate meeting, MMS Director Cynthia Quarterman stated that existing tendering programs were not set up to promote receipt of market value, but rather were used for royalty payment purposes. She stated further that tendering programs could promote opportunities to "game" royalty payments. Tendering, however, is the first of four benchmarks proposed for the Rocky Mountain Area under the proposed rule.

When asked why tendering or the other Rocky Mountain benchmarks could not be used elsewhere, Director Quarterman replied that there are few actual arm's-length sales in the Gulf of Mexico and that valid spot prices exist there. At least two Federal lessees, Conoco and Texaco, currently have tendering programs, and they are outlined briefly below.

Conoco's Tendering Program

Under Conoco's "bid-out" program, Conoco solicits bids from unrelated parties to purchase some or all of its crude oil production in various producing regions, and Conoco offers ten percent of its production volume for sale in each participating producing area. In many areas,

³⁶ We recognize that some lessees with a relatively small number of transactions may be able to trace production downstream without experiencing the same burden that the proposed rule would impose on larger lessees.

bidders may bid for any amount between ten and 100 percent of Conoco's crude oil production, and each sale that occurs is an outright cash sale. The term of the sale is six months, and the bid price is established as a premium or deduction from a relevant posting, generally Koch's. Conoco reserves the right to reject all bids; otherwise, it sells to the highest bidder. Conoco pays Federal royalties based on the values achieved under its tendering program.

In the fall of 1997, Conoco sold approximately 30,000 barrels per day outright through its tendering program. This represents approximately 50 percent of Conoco's equity production. In January 1998, the volume of barrels sold outright declined to approximately 15,000 per day, where it remains today.

Conoco requested that Dr. Joseph Kalt of The Economics Resource Group, Inc. review its program to evaluate whether the program could be relied upon to yield accurate measures of the market value at the lease.³⁷ Dr. Kalt's conclusion was "the bid prices revealed will generate a reliable measure of the fair market value of Conoco's crude at the lease or in the field."³⁸ He further states that the design and implementation of the bid-out program clearly meet the economic criteria for achieving fair market value.

Texaco's Tendering Program

After developing a tendering pilot in August 1995, and successfully testing it in the Offshore Louisiana Gulf, Texaco Exploration and Production Inc. ("TEPI") implemented tendering throughout the United States.³⁹ Today, TEPI tenders from approximately 12.5 percent to 20 percent of oil volumes from its marketing areas and generally an amount at least equal to its royalty share. TEPI's tendering program organizes marketing areas by oil type, and transportation method. Texaco believes its tendering program provides market value at the lease, "since the value assigned to the production reflects the price received in actual arm's-length transactions at the lease in the relevant marketing area." Tendering can enhance lease market competition and ensure that lease market value is realized. Texaco pays royalties based on values achieved under its tendering program. Indeed, tendering is the basis for valuation of TEPI's entire production in each market area, not just the royalty component. Since initiating its tendering program in 1995, Texaco has found that tendering 10 to 20 percent of production volumes is more than sufficient to establish competitive prices.

In Texaco's experience, tendering is less administratively burdensome than an index or other netback methodology that requires difficult, if not impossible, allocations, tracking, reports, and procedures.

³⁷ Appendix A contains a copy of Dr. Kalt's response to Conoco's request.

³⁸ Kalt letter, page 2.

³⁹ Texaco described the tendering program TEPI operates in comments filed with MMS on April 6, 1998 and this discussion is taken largely from these comments.

GATHERING VS. TRANSPORTATION

MMS has requested comments on "whether the definition of gathering should be modified to address"⁴⁰ situations where bulk, unseparated production is moved long distances from a sub-sea completion with no platform to a platform where it first surfaces and is treated. We believe that the definition of gathering should be clarified to affirm that all movement of production away from the lease is transportation.

Advances in technology have allowed economic development of deepwater fields utilizing subsea systems. Such systems do not, by their very nature, allow separation and delivery of production on the lease because of the absence of surface facilities. In some instances, subsea gas developments produce pipeline quality gas and do not require further treatment prior to compression for movement to shore. Often, however, such production is by necessity transported via pipelines significant distances away from the lease to other locations for separation, treatment, and/or transmission to shore. Pipelines in deepwater have higher capital requirements and have a greatly increased risk and uncertain economics associated with them. As projects in the Gulf of Mexico move into deeper and deeper water, and more structures projects involving long feeder lines come on line, this will become an increasingly important issue.

As a result of technological advances allowing drilling further and further offshore, the definitional change on which MMS is requesting comments is necessary to more accurately capture lease value.

In its July 24, 1998 "Summary of Industry recommended Improvements to MMS Oil Valuation Proposed Regulations and MMS Responses Discussed at July 22, 1998, Senate Meeting," MMS requests comments on whether it should consider developing a procedure to set pipeline transportation rates and correspondingly the transportation allowances for royalty purposes. MMS has no demonstrated expertise in the development of adequate pipeline transportation rates. If MMS were to begin setting pipeline transportation rates, it would result in the creation of a new administrative bureaucracy and a corresponding new burden imposed on lessees and pipeline affiliates. MMS should discard this option and instead rely on the reasonable commercial value of transportation as a basis for transportation allowances.

⁴⁰ 63 FR 38357

4. OUTSTANDING PROBLEMS FROM PRIOR PROPOSALS

MMS has received thousands of pages of comments on its proposed oil valuation rule, and although the proposed rule has been modified a number of times, substantial problems remain. This section briefly outlines the outstanding issues.

- ♦ *Proposed methodology will not capture value at the lease.* MMS asserts that its non-arm's-length netback methodology will capture market value at the lease, but what MMS would really capture is market value downstream of the lease. Even with the proposed adjustments, what MMS would capture is value in a different market than the lease market. The conceptual flaw in MMS' approach is that it focuses on allowable deductions rather than on the fact that value in one market may fail to replicate value in another market simply by picking the right adjustment factors. Requiring a lessee to net back from its or its affiliates' gross proceeds from downstream transactions with inappropriate adjustments certainly does not result in lease value.
- ♦ *Spot prices do not accurately reflect lease values.* Spot markets do not generally reflect local supply and demand conditions at the lease and can represent either a discount or a premium relative to term contract prices. Additionally, spot price assessments are based on a limited polling of traders and so do not reflect an average of spot transactions or even the price of any particular transaction. The proposed valuation method does not accurately take into account the volatile nature of oil price differentials between different locations and different grades of crude. The many local oil markets in the U.S. do not move in lock step with each other because of the influence of local supply and demand factors.
- ♦ *Data from Form MMS-4415 not usable for intended purpose.* MMS will not be able to derive meaningful location and quality differentials between aggregation points and market centers from the data to be collected on Form MMS-4415. Indeed, there are potentially serious problems with the statistical accuracy and representativeness of the differentials MMS proposes to publish. Even more troubling, however, is that at the February 18 hearing in Houston, an MMS official said that MMS planned to wait to see the Form MMS-4415 data before figuring out how to use it. He also confirmed that MMS has performed no prototyping or pilot testing.
- ♦ *Proposed methodology results in inaccurate values in each region.* In addition to system-wide inaccuracies, MMS' proposed regional schemes introduce their own inaccuracies.
 - ◊ *California/Alaska.* Alaska North Slope (ANS) spot market crude oil sales represent the sale of a different kind of product than onshore California crude oil at the lease. While both products are crude oil, they are of different qualities available in different quantities at different locations under different contract terms. These tangible and intangible differences in markets are reflected in a higher level of volatility in price differentials between ANS crude and California crudes. As a result, the proposed methodology will not result in an accurate measure of onshore lease value.
 - ◊ *Rocky Mountain Area.* MMS has not fully considered the problems and inaccuracies associated with each of the four benchmarks for the Rocky Mountain Area. The

restrictions imposed on the tendering program could easily result in a lower value being received for tendered oil. The volume-weighted average benchmark will result in overvaluation for some oil and is also subject to significant restrictions. The NYMEX benchmark will not result in an accurate lease value, and the final benchmark where a lessee uses an MMS-established methodology relies on subjective decisions on the part of MMS. Because of the restrictions placed on the first two methods and the many inaccuracies associated with the NYMEX method, it could well be that a substantial share of Rocky Mountain Area production is forced to be valued using a far less certain and yet to be determined method than exists under today's benchmark methodology. MMS also asked for comments on the composition of the Rocky Mountain Area. A debate over whether all or some portion of New Mexico should be included in the defined area misses the fundamental issue. While crude oil produced in the Rockies is subject to different market pressures than crude produced in some other parts of the country, this is not equivalent to characterizing the Rockies as a single market. As discussed above, we believe that all crude oil markets are inherently local and subject to their own supply and demand characteristics. While these local markets may be affected by the value of crude oil sold elsewhere, this is not the same as saying that the value of crude oil produced in one locality can be determined formulaically by the value of crude in other localities.

- ◊ *Rest of the country.* MMS has not carefully considered each region and local market in the rest of the country when developing this methodology. Some Federal leases are hundreds of miles from a defined aggregation point or market center, and MMS requires lessees to use the spot price at the market center closest to the lease to value crude oil not sold at arm's-length. If the closest spot price is many hundreds of miles away, this may bear little relationship to the local market and will not result in an accurate value at the lease. MMS also requires the lessee to use the spot price for the crude oil most similar in quality to its oil. It is not clear what the lessee should do when these requirements conflict. For example, what should the lessee do when sour crude oil production is closest to Cushing? Should it use a West Texas Sour spot price at Midland, even though Midland is 500 miles from Cushing, because it is most similar in quality, or the Cushing price?

5. PROCEDURAL ISSUES

In promulgating regulations, agencies must follow certain procedural requirements including those prescribed in the Administrative Procedures Act (APA), the Paperwork Reduction Act of 1990, the Regulatory Flexibility Act (RFA), and Executive Order 12866. This section describes procedures that MMS appears not to have complied with.

MMS reopened the comment period on the proposed oil valuation rule for two weeks on July 8, 1998. On July 16, 1998, MMS released a second supplementary proposed rule with comments due on or before July 24, 1998: a comment period of just 8 days. The APA requires comment periods of 60 days, and so it appears that MMS has not complied with this procedural requirement.

Further, it is generally the case that before a rule is published in the Federal Register, the Office of Information and Regulatory Affairs (OIRA) of the Office of Management and Budget (OMB) reviews and approves the rule before publication. All rules that are under OIRA review appear on OMB's web page.⁴¹ The most recent version of the rule, however, never appeared there. Further, when Barents contacted the Desk Officer for the Department of the Interior he stated that he did not know why it had not been forwarded to OMB for review.

The rule as revised will cause substantially more lessees to value their production based on non-arm's-length methods, which has at least two implications.

- ◆ First, MMS should revise its Executive Order 12866 cost-benefit analysis. The revised rule will require many more independents to value their production using non-arm's-length methodologies because of the single exchange provision. In its original analysis, MMS had assumed that all independents would remain on gross proceeds and so attributed no increased revenue to them. Second, the revised definition of affiliate could further invalidate MMS assumption that all integrated companies would value their oil for royalty purposes using the non-arm's-length method. As a result, MMS \$66 million estimate is no longer valid.
- ◆ Second, MMS should fully consider the impact on small business. The RFA defines certain procedures that must be followed in estimating the burden on any regulation on small business. MMS certified that "[the February 1998] rule will not have a significant economic effect of a substantial number of small entities under the Regulatory Flexibility Act (5 U.S.C. § 601 et seq.)."⁴² Under the Regulatory Flexibility Act (RFA), a small entity is a small business (per SBA definitions – for exploration and production companies, it is less than 500 employees), a "small organization" means any not-for-profit enterprise which is independently owned and operated and is not dominant in its field, or a "small governmental jurisdiction" means governments of cities, counties, towns, townships, villages, school districts, or special districts, with a population of less than fifty thousand. MMS states that most of the 600 oil payors are considered small businesses under the RFA, yet in describing its burden estimate on small business, MMS uses a definition based on annual production

⁴¹ <http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html>

⁴² 63 FR 6123

levels not number of employees. MMS describes estimate of burden of completing proposed Form MMS-4415 on companies with less than 10 million but greater than one million barrels of production per year (35 Federal lessees in 1996) as being 29.25 hours for companies of this size for a total burden of 1,023.75 hours.

In conversations with the Small Business Administration (SBA), the SBA said that MMS has not been fully complying with RFA requirements and that if MMS is not in full compliance within one year, the SBA will be required to take further action. This rule is likely to have a substantial impact on small business, and we consider SBA's comment to be inappropriately lenient and believe that MMS must fully comply with RFA requirements under the proposed rule.

6. CONCLUSION

The July 1998 version of the proposed oil valuation rule does not solve the problems contained in earlier versions of the rule and may even create new problems. Language contained within the current version allows MMS to "second-guess" values received in arm's-length transactions, and MMS' single exchange provision will significantly affect many lessees by placing more of their transactions on an index valuation methodology.

As a result of our analysis of the proposed rule, and as discussed further below, MMS should fully commit its resources either to revising the existing regulations or to the further development of a viable royalty-in-kind program.

MMS published its original proposed rule on January 24, 1997, and in response to numerous comments, released the most recent version of the rule on July 16, 1998. The July 1998 version does not solve the problems contained in earlier versions of the rule and even creates new problems. The current version will allow MMS to "second-guess" values received in arm's-length transactions, and MMS' single exchange provision will significantly affect many independent producers by placing more of their transactions on an index valuation methodology.

The costs and inefficiencies that would be imposed on lessees by the further supplementary proposed rule are entirely avoidable and unnecessary because an active market exists for oil at the lease that would allow a more straightforward and less costly approach to royalty valuation. In addition, a serious, carefully developed, alternative approach is now under congressional consideration: royalty-in-kind (RIK). Two hearings have been held on RIK legislation and a bill has been reported by the Subcommittee on Energy and Mineral Resources of the House Committee on Resources. RIK legislation would require that the Federal government take royalty in kind production at the lease. By using private sector qualified marketing agents to market its production, the U.S. Government would achieve greater certainty than the proposed rule envisions but would do so in a way that is much less administratively burdensome, and clearly captures accurate arm's-length values through outright sales. Indeed, MMS has studied the feasibility of royalty-in-kind for natural gas in the Gulf of Mexico, has initiated a crude oil royalty-in-kind pilot program in Wyoming, and is initiating a crude oil royalty-in-kind pilot program for offshore Texas.

It makes little sense to completely restructure the current crude oil valuation system, as would be required if the further supplementary proposed rule were to be finalized, when serious efforts, including an MMS pilot program, are underway to develop a better system with broad industry support. A properly structured royalty-in-kind program will allow MMS to achieve its goals without the unnecessary administrative complexity and burden that would be imposed by MMS' second further supplementary proposed rule.